No. 11251

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

CONSTANCE MAY GAVIN,

Appellee.

BRIEF FOR THE APPELLEE.

LESLIE L. HEAP,
829 Citizens National Bank Building, Los Angeles 13,
Attorney for Appellee.

Of Counsel:
HAROLD A. THOMPSON.

Parker & Company, Law Printers, Los Angeles. Phone TR. 5206.

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BRIEF FOR THE APPELLEE.

Opinion Below.

The memorandum opinion of the Court below is reported in 63 F. Supp. 425. [R. 29-31.]

Jurisdiction.

Appellant's statement *re* jurisdiction is substantially correct. The judgment appealed from was for the refund of 1934 income taxes and interest thereon. [R. 38-42.] Such taxes were paid in four installments in 1938. [R. 4, 5, 13, 28, 35, 36.] A claim for refund was filed May 9, 1941 [R. 7-10, 14, 28, 36] and the same was disallowed by the Commissioner of Internal Revenue on January 6, 1943. [R. 6, 14, 28, 36.] Appellee filed the original action in the District Court on January 2, 1945 within time provided in Section 3772 of the Internal Revenue Code. [R.

2-11.] The said District Court gave judgment to Appellee and the same was entered on August 20, 1945 and an amended judgment, by stipulation, was entered October 4, 1945. [R. 38-42.] The government filed notice of appeal therefrom on or about November 19, 1945 pursuant to Section 128(a) of the Judicial Code, as amended. [R. 42.] Jurisdiction of the original action was conferred on the United States District Court by paragraph 20 of Section 24 of the Judicial Code. [R. 3, 12.]

Question Presented.

Whether the value of the settlement received by Appellee in compromise of her litigation against the Flood estate and the representatives thereof for a pretermitted daughter's share (2/9ths) of said estate constituted taxable income to the recipient?

Statutes Involved.

The applicable statutes are set forth in the Appendix, *infra,* pp. 1 to 4.

Statement of Facts.

There is no dispute about the facts. Most of them are admitted by the government's answer. The others are covered by a Stipulation of Facts. [R. 24-28.] The Statement in the Appellant's brief is not a fair statement. It is very incomplete and very misleading. For the most part it is merely a copy of one paper, in the nature of a release, that was signed in connection with the settlement. The true facts, as admitted by the answer or as set forth in the above mentioned stipulation and the Exhibits referred to therein, were as follows:

The Appellee, from the time she was three (3) months of age, lived in the home of James L. Flood as a member

of his family. She traveled with him as his daughter and she was raised and educated by him and otherwise recognized and treated as his daughter. [R. 65-74.]

Said James L. Flood died testate in San Mateo County, California, on or about February 15th, 1926. His last Will and Testament was admitted to probate by the Superior Court in said County on March 11, 1926 and James E. Walsh and Maud Lee Flood were appointed Executors thereof. Mr. Walsh died in 1932 and Maud Lee Flood continued as the sole Executor thereafter. She was the widow of said decedent and James Flood and Mary Emma Flood were son and daughter respectively of said decedent. Cora Jane Flood was a sister of the decedent and she died in November, 1928, during administration.

James E. Walsh and Maud Lee Flood were also trustees under the Will of said decedent and in 1931, they, as such trustees, sold 4295 shares of Flood Realty Company stock to the Flood Realty Company, and at the time of distribution of the estate said Maud Lee Flood consented to distribution of said 4295 shares to said company.

On March 13, 1927, the Appellee herein, filed in the Court probating said estate, a petition for partial distribution, claiming that she was entitled to 2/9ths of said estate as the daughter and pretermitted heir of said decedent and asking for distribution of a portion of said estate to her. A trial of said matter was had before a jury and the trial Court directed a verdict against the Appellee herein in August, 1931 and a judgment was entered against her. She appealed therefrom and on April 18th, 1933 the Supreme Court of California (in Bank) reversed said decision and remanded the cause for a new trial. The Supreme Court's opinion is reported in 217 Cal. 763 and a copy thereof is in evidence here marked Exhibit "A". [R. 59-85.]

Between May 20th, 1933 and February 28th, 1934, a compromise settlement was arranged under which the following things were to and did occur:

1. Said litigation was to be settled and terminated and it was settled and terminated on February 28, 1934, in the manner hereinafter set forth.

2. Plaintiff in said case (Appellee here) was to receive 2/3rds of the amount sought in her petition for final distribution or 4/27ths of the Estate of James L. Flood that became available for distribution and plaintiff or her assigns have in fact received that portion of said estate in kind. Appellee and her assigns received $100,000 cash in lieu of a 4/27ths interest in the corporate stock of Rancho Santa Margarita, a corporation, and certain real property in San Francisco, California, both of which were covered by the residuary clause of the Will. [R. 120, 121, 135, 157.]

3. Plaintiff in said case (Appellee here) was to sign a certain document designated as an Agreement and deliver it to the representatives of said estate. She did so and a copy of the same is in evidence marked Exhibit "B". [R. 86-94.]

4. Petitioner in that case (Appellee here) was to permit and on February 28th, 1934, did permit her said Petition for partial distribution to come on for hearing without contest, whereupon Findings of Fact, Conclusions of Law and a Judgment disposing of said petition were entered on February 28th, 1934. A copy of the Minutes of said proceedings and copies of the said Findings of Fact, Conclusions of Law and Judgment

are in evidence marked Exhibit "C". [R. 95-104.]

5. On the same last above mentioned date, to-wit February 28, 1934 a Decree for the Final Distribution of the Estate of James L. Flood, was to be and in fact was made and entered by the same Probate Court and Judge that made the last above mentioned Findings of Fact, Conclusions of Law and Judgment. [R. 101, 104, 122.] Said Decree of Final Distribution is in evidence marked Exhibit "D". [R. 104-122.] The distributions therein provided have been made to Plaintiff and her assignees, *Eugene Aureguy, John J. Taaffe, Maxwell McNutt, Albert Mansfield* and *Carmelita Aureguy.*

The government claimed that the money and property so received by Appellee was subject to income tax and taxable as a gain on capital held more than 5 and less than 10 years. [R. 4, 160.] Appellee, in an effort to comply with the demands of the Revenue Department, filed an Income Tax Return on or about May 10th, 1938, which said return covered the year 1934. A copy of the same is in evidence marked Exhibit "E". [R. 159-160.]

Appellee paid the Collector of Internal Revenue the alleged income taxes and interest in the amounts and on the dates set forth in her complaint here [R. 5] and in the Findings made in this case. [R. 36.] Thereafter, she filed her claim for refund which was disallowed by the Commissioner of Internal Revenue on January 6th, 1943. This suit followed and Appellee had Judgment as set forth in the record. [R. 29-41.]

Statement of Points to Be Urged.

The District Court correctly decided this case. Appellee was and is entitled to said refund. The settlement received by her in compromise of said litigation was not income and was not taxable as such. If income, such receipts were within the exclusion of 22(b)(3) of 1934 Revenue Act. *Appendix, infra.*

Summary of Argument.

Income had been defined by the Supreme Court of the United States prior to the adoption of the Sixteenth (16th) Amendment to the United States Constitution and the word *income* was used in the Sixteenth (16th) Amendment according to the meaning of the term as previously defined. Money or property received from an estate and its representatives in settlement of litigation brought by a person to recover his or her interest in said estate is *not income* within the meaning of that term as used in the Sixteenth (16th) Amendment. *Appendix, infra.*

The settlement received by the Appellee in compromise of her said litigation was *an acquisition in devolution of a decedent's estate* and was in the nature of an *inheritance* within the *principles* enunciated by the Supreme Court in *Lyeth v. Hoey,* 305 U. S. 188. If her litigation had been carried to the bitter end, distribution to her as the pretermitted daughter would not have been taxable income. What she received in settlement is of the same character. So, why should it be taxable? Certainly she gained nothing because she took less than the amount which would have been distributed to her upon the successful conclusion of her litigation. The settlement receipts were therefore not taxable as income.

ARGUMENT.

I.

None of the Value of the Money or Property Received by Plaintiff Was Income in Any Sense.

The Government's main premise here, as shown by their brief, is that everything that a person may receive is *income* and is taxable unless the same can be specifically excluded or exempted under some exclusion or exemption provided in the Revenue Act. In our opinion, that premise is false. The Government also assumes and wants the Court to find that *Mrs. Gavin* was not an heir and was not entitled to anything because she settled her case instead of going on with the litigation. They go further and assume that if anyone claims an interest in an estate as an heir and settles the claim, the amount received is taxable income unless the person retries, in a Federal Court, the very case that he or she settled in the State Court and proves to the Government that he or she was an heir and would have won the case in the State Court. We cannot agree with this proposition. In the first place, it is ridiculous because to retry such a case in a Federal Court could not prove or disprove what the result would have been in the State Court. Furthermore, it is our opinion that none of the authorities cited or relied upon by the Government uphold or support that contention.

The Appellant's brief devotes much space to a certain statement, in the nature of a release, which was signed by Mrs. Gavin only, as though that was the only fact in the record. The truth of the matter is that that is only one of the many things that were to be done to carry out the settlement arrangement. As shown by the stipulation of facts here [R. 26] many months (May 20, 1933 to February 28, 1934) were devoted to the arrangement of that

settlement, and during that time the various details of the settlement were worked out, and the parties and their counsel (as is usually the case) orally agreed to the terms of settlement and provided that the things enumerated in our stipulation of facts here were to be done, and those things were done to carry out the settlement. [R. 26-27.] One of those things was the statement *signed only by Mrs. Gavin.* Another was the termination of the suit. Another was the Decree of Distribution. All of these were done *at the same time, in the same Court, before the same Judge.*

The Government also spends much space arguing that what Mrs. Gavin and her assignees received came from the beneficiaries under the Will and not from the estate. That argument likewise is ridiculous. Here, the Will left the estate to certain beneficiaries named therein including Maud Lee Flood as a trustee under certain trusts. *Mrs. Gavin* was not named in the Will. She was pretermitted and she sought her share as such pretermitted daughter. We should like to have the Government's counsel tell us how it would have been possible to distribute any of the estate to *Mrs. Gavin* without reducing the shares of the beneficiaries named in the Will. Most certainly, that could not be done. Accordingly, the shares of the beneficiaries were reduced, and cash was raised, in order to make distribution to Mrs. Gavin and her assignees as agreed upon in the oral settlement arrangement. Pursuant thereto Mrs. Gavin and her assignees received 4/27ths or 2/3rds of 2/9ths of said estate in kind under the Decree of Distribution; and in working out the settlement she and her assignees took $100,000 cash in lieu of 4/27ths of the corporate stock in the Rancho Santa Margarita and certain San Francisco real estate which went to the residuary devisees and legatees. In other words, she took 4/27ths of

the estate and what she received was *an acquisition in devolution of a decedent's estate* and came to her as a result of the death of Mr. Flood and her determined effort to recover her share as his pretermitted daughter.

With reference to what is or is not income, we note that the Government insists that everything she received was taxable unless it comes within Section 22(b)(3) of the Revenue Act of 1934. *Appendix, infra.* We cannot agree with that proposition either. If what she received was *income* within the 16th Amendment of the United States Constitution, their proposition might be true, but we contend that it was *not income* at all.

We observe that Section 22(a) of the Revenue Act of 1934, *Appendix, infra,* provides that gross *income* shall include "gains or profits and income derived from any source whatever." This provision is not a definition of *income* because it includes the term to be defined. The same is true of Section 21 of the Act. *Appendix, infra.* After all it is *income* that the statute refers to and in the exclusions it is referring to exclusions from *income.* That is, you must have *income* in the first place, before the Act applies at all. We contend that what she received was *not income,* and that no case, except the case of *Kearney v. Commissioner,* 31 B. T. A. 935, and those based thereon which were later *overruled* by *Segebade v. Magruder,* C. C. A. 1938, 94 F. (2d) 177; *Lyeth v. Hoey,* 1938, 305 U. S. 188; and *Keller v. Commissioner,* 1940, 41 B. T. A. 478, acquiesced in by the Commissioner, has so held.

The settlement received by Mrs. Gavin was neither a gain nor a profit nor income. It was *capital* which she claimed she was entitled to and she sued to get it. She settled and took *less* than she was entitled to. How and on what theory can that be taxable as *income?*

We pause to point out that the following receipts have been held by the Supreme Court not to be income although not expressly exempted by the Revenue Act:

> Stock Dividends, *Eisner v. Macomber,* 252 U. S. 189; *Helvering v. Griffiths,* 318 U. S. 371; Alimony, *Gould v. Gould,* 245 U. S. 151; Money subsidies granted by the Cuban Government to an Illinois Railroad to promote construction of railroads in Cuba, *Edwards v. Cuba Railroad,* 268 U. S. 628.

The Government has no right to levy an income tax except under and by reason of the Sixteenth (16th) Amendment to the United States Constitution, which reads:

> "The Congress shall have power to lay and collect taxes on *incomes,* from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." (Italics ours.)

Congress has not defined *"income"* but *"income"* has been defined by the United States Supreme Court on a number of occasions. That word was defined by the United States Supreme Court *before* the adoption of the Sixteenth (16th) Amendment. As that Court pointed out in *Merchants Loan and Trust Company v. Smietanka,* 255 U. S. 509, the Corporation Excise Tax Act of 1909 was *not an income tax law,* but that a definition of the word *"income"* was so necessary in its administration that in the early case of *Stratton's Independence, Ltd. v. Howbert,* 231 U. S. 399, it was formulated as "a gain derived from capital, from labor, or from both combined."

In *Eisner v. Macomber,* 252 U. S. 189, the Supreme Court reiterated the definition of *"income"* which had

been approved in the case of *Straton's Independence, Ltd. v. Howbert, supra,* and *Doyle v. Mitchell Bros. Co.,* 247 U. S. 179, as follows:

> "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets, * * *"

The Court in the *Merchants Loan and Trust Company* case, *supra,* further pointed out that the word "income" under all Income Tax Laws means the same as it did under the said Corporation Excise Tax Act and that that meaning has now become definitely settled by the decisions of the Supreme Court, and the Court in that case (page 519) said,

> "In determining the definition of the word 'income' thus arrived at, this Court has consistently refused to enter into the refinements of lexicographers or economists, and has approved, in the definitions quoted, what it is believed to be the *commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution.*" (Italics ours.)

In the District Court proceedings on the case at bar Appellant's counsel cited and referred to the case of *In re Owl Drug Co.* (1937), D. C. Nevada, 21 Fed. Supp. 907, 20 A. F. T. R. 729, as supporting the Government's position. We have observed that the Honorable Judge Yankwich in that case said this:

> "In defining the word 'income' in tax statutes enacted under the Sixteenth Amendment to the Constitution, the criterion adopted by the courts has been 'the commonly understood meaning of the term.' *Mer-*

> *chants' Loan & Trust Co. v. Smietanka* (1921), 255 U. S. 509, 519, 41 S. Ct. 386, 388, 65 L. Ed. 751, 15 A. L. R. 1305. This has been called the *'man on the street' concept of what income is.* Paul & Mertens, Law of Federal Income Taxation, 5.02-5.03. 'Income' is all 'gain derived from capital, from labor, or from both.' *Stratton's Independence v. Howbert* (1913) 231 U. S. 399, 415, 34 S. Ct. 136, 140, 58 L. Ed. 285. * * *" (Italics ours.)

The Appellee did not invest her capital; she was suing to get it. The amount received by her under the compromise was not the result of an investment, but a realization of a substantial portion of the share of the etsate which she was suing for as a pretermitted daughter. It was just as much so as if she had successfully completed her litigation on her petition for partial distribution of the estate. It is not possible for a person to derive a gain from capital until he has obtained possession or control of the capital.

Likewise she did not derive a gain from labor. Whatever labor was put forth was performed by her attorneys and investigators in conducting the litigation and the negotiations resulting in the compromise settlement. For that labor her attorneys and investigators received one-half of the settlement. That labor did not result in a gain to Appellee, but it did result in her realization and receipt of a portion of the share she was suing for as the decedent's pretermitted daughter. She had the legal right to contest his Will to establish her claim and she was exercising that right. It was her *standing or status in that capacity that commanded the compromise settlement.*

In *Merriman v. Commissioner,* 55 F. (2d) 879 (C. C. A. 1), it was held that a will contest is not a transaction

entered into for profit and that attorneys' fees and expenses paid by an unsuccessful contestant are not deductible losses. On page 880 the Court said:

> "When the petitioner brought her suit to break her aunt's will, it was to establish her right to what she must have claimed honestly belonged to her. * * * If the litigation had proved successful, she would have received only such part of the testator's estate as justly belonged to her. That would not have been profit. The litigation was unsuccessful. Her anticipated share in the estate was denied her. It was not loss because she never possessed it. To hold that the expenses of litigation under the existing facts were a deductible loss because incurred in a transaction entered into for profit would be *straining the meaning of 'profit' beyond any ordinary or usual meaning of the word and beyond the sense in which it was used by Congress.*" (Italics ours.)

If a transaction cannot be productive of income for the purpose of deducting expenses, surely it must be likewise unproductive of income for the purpose of levying an income tax.

At this point we make the following observation: James L. Flood died in 1926. The Flood Estate was subject to Federal Estate Tax and the same was calculated and paid a long time before the settlement with Appellee in 1934. Suppose, that the Executor of the Flood Estate had, after the settlement, claimed a deduction from or refund on said Estate taxes on the theory advanced in the case of *Howard v. Commissioner,* B. T. A., Docket No. 109188 (Dec. 1943), that the amount paid to *Mrs. Gavin* on her claim was a deductible item. *Query:* Would counsel for the Government (one of whom represented the Government in the *Howard* case) have approved such item as a

deduction or for refund or would they have contended, as in the *Howard* case, that what *Mrs. Gavin* received was *"by way of inheritance"* and therefore not deductible? We feel certain that they would have taken exactly the same position as was taken by them in the *Howard* case, which we believe was correct.

Furthermore, in the transaction at bar, there was no gain or profit from the sale, exchange or conversion of assets. If Appellee had prosecuted her claim and litigation to a successful conclusion the amount received would not have been income, profit or gain and would not have been taxable. Likewise, if she had been unsuccessful in the litigation there would have been no income, gain or profit and there could have been no tax, nor could she have deducted any of the expense or attorney's fees under the authority of the *Merriman* case, *supra.* Still the Government contends that because she compromised the litigation she received taxable income, even though they must admit that a final decree, either for or against her, would have resulted in no tax. Such reasoning is fallacious and untenable.

Fundamentally, the compromise of a claim is not an exchange or sale which results in a profit. Here, Appellee asserted her rights as a pretermitted daughter of the decedent and claimed a property right in his estate, to-wit 2/9ths thereof. The compromise resulted in her receiving (between herself, her attorneys and her investigators) 2/3rds of said 2/9ths or 4/27ths of said estate, or 1/3rd of 2/9ths less than she was claiming and entitled to. She therefore gave up 1/3rd of her share rather than to litigate further. It is utterly ridiculous for anyone to contend that such a transaction is an exchange, sale or conversion of assets resulting in a gain or profit to her.

The common sense rule is that the *nature* of the claim itself determines whether or not the avails are income, gain or profit and it makes no difference whether or not the claim is compromised or litigated to a judgment. This rule is supported by the authorities.

Central R. R. of N. J. v. Commissioner, 79 F. (2d) 697 (C. C. A. 3rd);

Hawkins v. Commissioner, 6 B. T. A. 1023 (Acq.);

Farmers and Merchants Bank of Catlettsburg, Ky. v. Commissioner of Internal Revenue, 59 F. (2d) 912 (C. C. A. 6th);

Gould v. Gould, 245 U. S. 151.

The foregoing cases and numerous others all support the rule that it is the *nature* of the claim itself that determines whether the avails are taxable.

If the Appellant's contention should be adopted, the practical results would be intolerable because no one could compromise such a claim without making the proceeds which would otherwise be tax exempt, taxable. Under the present rates of taxation compromise settlements of litigation would virtually cease, in spite of the commendable and equitable rule that the law favors compromises.

On principle and under the authorities it appears perfectly clear to us that amounts received in such compromise settlements are *not income* and therefore not taxable as such.

The first case in which the Government taxed such amounts as income was *Kearney v. Commissioner,* 31 B. T. A. 935. That was a Board decision by one member of the Board. The theory there was that amounts received in the compromise settlement of the Will Contest was a gain "derived from capital, from labor, or from both com-

bined," in that the taxpayer exchanged or sold a right or claim, which cost him nothing for that which he received, and that the amount received was therefore profit or gain. That case was decided in 1934 and was not appealed by the taxpayer.

The Government relied upon that decision in taxing *Lyeth* in *Lyeth v. Hoey,* 20 F. Supp. 619. Judge Coxe of the District Court decided that such compromise payments were *not within the definition of income.* In that case Judge Coxe said:

> "The property received by the plaintiff is not within this definition. It was *not a gain* derived from capital. The plaintiff was not investing his capital *but trying to obtain it.* There was no gain, either, from labor. The will contest was not entered into for profit. Neither was the legal expense deductible as a loss. *Meriman v. Commissioner* (C. C. A.) 55 F. (2d) 879. No more was it productive of income. I do not think, therefore, that the property received was *in any sense income."* (Italics ours.)

In that case Judge Coxe in speaking of the *Kearney* case also said:

> "The government relies heavily on the case of *Bernard O. Kearney,* 31 B. T. A. 935, decided by one member of the Board of Tax Appeals. * * * The board member thought that the taxpayer realized a gain because he had rights which 'cost him nothing,' and these rights were given up 'in exchange for $23,333.34.' The fallacy in the argument is that no rights were given up which resulted in gain. The property which the petitioner sought to recover was something which he believed he was entitled to by inheritance. When the litigation was settled, he only received part of what otherwise would have come to

him if the will had been overthrown. I think this should have been held to be *capital* and *not income.*

It is unnecessary to decide whether the property received by the plaintiff is within the exemption provision of section 22(b)(3) of the Revenue Act of 1932 * * *; it may still be nontaxable although not covered by any specific exemption." (Italics ours.)

This decision was reversed by the Second Circuit Court in *Lyeth v. Hoey,* 96 F. (2d) 141, on the ground that such payments constituted income within the definition laid down in Section 22(a) of the Internal Revenue Code. However, it is important to observe that the United States Supreme Court in *Lyeth v. Hoey,* 305 U. S. 188, *reversed* the Second Circuit Court and *affirmed* Judge Coxe's decision in the District Court, and at the end of the opinion, the *Honorable Charles Evans Hughes,* said:

"* * *. We are of the opinion that the exemption applies.

In this view we find it unnecessary to consider the other questions that have been discussed at the bar.

The judgment of the Circuit Court of Appeals is *reversed* and that of the *District Court is affirmed."*

(Meaning of course, Judge Coxe's decision.) (Italics ours.)

It is therefore obvious that the Supreme Court repudiated the unsound "capital gain theory" adopted by the Second Circuit Court in that case and the Board member in the *Kearney* case.

The Fourth Circuit Court decision in *Magruder v. Segebade,* 94 F. (2d) 177 (1938), is a strong and controlling case upholding Appellee's contention that what she

received was *not income* within the Sixteenth Amendment. The Circuit Court in that case, on page 178, said:

> "The sole question raised on this appeal is whether the amounts received by the plaintiffs under the compromise constitute taxable income."

Then after pointing out that neither Congress nor the Sixteenth (16th) Amendment empowering Congress to tax incomes had defined the term "income", but the Supreme Court had defined it in the following cases: *Stratton's Independence, Ltd. v. Howbert,* 231 U. S. 399; *Eisner v. Macomber,* 252 U. S. 189; and *Bowers v. Kerbaugh-Empire Company,* 271 U. S. 170, the Circuit Court, in a unanimous opinion, said:

> "Considering the facts in this case in the light of the decisions of the Supreme Court, the Acts of Congress, and the Regulation of the Commissioner of Internal Revenue, we are forced to the conclusion that *the amounts received by the plaintiff did not constitute income within the meaning of the Sixteenth Amendment.*
>
> The plaintiffs would have received a greater amount under the first will than under the later will. Had they been successful in contesting the second will and establishing the first will as valid, the amount that would have been received by them would undoubtedly have been a bequest or inheritance and no reasonable contention could be made that the whole amount was taxable income. *Does the fact that they agreed, by way of compromise,* to accept a lesser amount, a part instead of the whole, *change the character of what was received?* Was it not still a bequest or inheritance, although they surrendered a part of it rather than run the chance of litigation?

It is not necessary to decide these questions for certainly there was no gain derived from either capital or labor or from a sale or conversion of capital assets.

The precise question involved here was considered in the case of *Lyeth v. Hoey,* D. C., 20 F. Supp. 619, where the amount received by the compromise of a contested will was involved. *Judge Coxe, in a well-considered opinion, reached the same conclusion as was reached here by the court below.*

It is contended on behalf of the defendant that the sums received by the plaintiffs were acquired by purchase under a contractual arrangement and a decision of the Board of Tax Appeals in *Kearney v. Commissioner,* 31 B. T. A. 935, holding to that effect is relied upon. In the Kearney case the Board held that there was a gain to a taxpayer, compromising a will contest, 'derived from capital, from labor, or from both.' *We do not approve of the reasoning of the Board in this case.* There is more reason for holding that the amounts received by the plaintiffs come within the meaning of the words used in the exemption granted in the Revenue Act of 1934, above quoted, than for holding that they were taxable income.

* * * * * * * *

The results of a compromise of rights, the proceeds of which rights are not taxable, do not become taxable because the compromise was brought about by an agreement not to litigate." (Italics ours.)

We believe therefore that on principle as well as authority we have shown that what Mrs. Gavin received in the compromise settlement was not *income* and therefore was not taxable as such.

II.

What Appellee Received Was an Inheritance and an Acquisition in Devolution of the Decedent's Estate Within the Provisions of Section 22(b)(3) of the Revenue Act of 1934.

As hereinabove shown, Appellee received no *income* in any sense. That which she received was in the nature of an *inheritance* and was *an acquisition in devolution* of the Estate of Flood. The property (4/27ths of the estate) was distributed to her and her assignees (attorneys and investigators) under the Decree of Distribution of the Probate Court having jurisdiction thereof. [R. 104-158.] She and her assignees also received $100,000 cash from James Flood, the son of the decedent, Mary Emma Flood (Stebbins), daughter of the decedent, and Maud Lee Flood, the decedent's widow, who was also Executrix and Trustee of decedent's estate. This money was received in lieu of 4/27ths of the corporate stock of Rancho Santa Margarita, a corporation, and the above mentioned real estate in San Francisco which went to Maud Lee Flood, James Flood, and Mary Emma Flood (Stebbins) as *residuary devisees and legatees.* As shown by the decree of distribution herein [R. 104, 158], Mrs. Gavin did not receive any portion of these specific properties. It is perfectly obvious that a minority interest in that ranch corporation (now Marine Base, Camp Pendleton) and in the said San Francisco property was worth much more to the holders of the majority interest therein (residuary devisees and legatees) than it would have been in the hands of Appellee and her assigns.

Appellee as the pretermitted daughter of decedent had, in March 1927, filed a petition for partial distribution to recover 2/9ths of said estate. This was pursuant to Sec-

tion 230 of the Civil Code of the State of California and Sections 90 and 91 of the Probate Code of California (*Appendix, infra*), and, under said sections she not only had the right to, but did vigorously maintain and prosecute those proceedings. Under Section 90 of the Probate Code intestacy is created as to a pretermitted child and under Section 91 of that Code, the devisees and legatees must abate their respective shares proportionately and provide for said pretermitted daughter. To prevent further litigation and to settle the matter, the parties after years of litigation (1927 to May, 1933) began arranging for a compromise and between May, 1933 and February 28th, 1934 worked out an arrangement and the details thereof. In accordance with that arrangement she was to receive $100,000 cash and 4/27ths of the estate, except the said San Francisco real property and the corporate stock in Rancho Santa Margarita; and by the arrangement her said assignees were to receive 1/2 of said settlement. The compromise arrangement therefore determined the amount to be received by Appellee and her assignees. The Probate Court then made a Decree of Distribution in accordance with said compromise arrangement.

We contend that in any case where a Probate Court directs the transfer or distributes the decedent's property to a person not named in the will, the property is acquired by *inheritance.* In any event, property so acquired by the distributee is *an acquisition in devolution of the decedent's estate.*

The Probate Court is bound by certain rules of law in distributing a decedent's estate: (1) the laws of decent and distribution if no will is probated; (2) the law permitting the probate of a will with the legal requirements as to testamentary capacity, absence of undue influence,

etc.; (3) the law permitting distribution of the estate where there is a contest, in accordance with a compromise agreement approved by the court; (4) the law requiring the court to name the persons and the proportions or parts to which each is entitled in its decree of final distribution. See Sections 1020 and 1021 of the Probate Code of California. *Appendix, infra.*

No matter which laws govern the distribution of a decedent's estate, such a distribution is *an acquisition by the distributee in devolution of a decedent's estate* within the intent of Congress in adopting the provisions of Section 22(b)(3) of the Revenue Act of 1934. *Appendix, infra.*

Suppose, for example, that a California resident devised and bequeathed his separate property in trust for the benefit of his wife for life with the remainder to a stranger, there being no children, and suppose, the wife contests the Will as being made under undue influence, and prior to a suit on the merits, an agreement is reached whereby the Will is not to be admitted to Probate and that the wife and the stranger shall each take one-half (1/2) of the estate outright. Assume further that the Court approves the settlement agreement and in accordance therewith distributes the property to them. Neither the wife nor the remainderman (stranger) would take under the Will. The stranger would get something very different than the remainder provided for in the Will. He would get a present interest in one-half (1/2) of the estate. The wife likewise would not take under the Will but under the law of descent and distribution. That couldn't be true of the remainderman because he is a stranger and not related to the decedent. Technically, the stranger would not take by inheritance, bequest or devise. It would be *an acquisition in devolution of a decedent's estate* pur-

suant to the agreement and the order or decree of the Probate Court distributing the decedent's estate.

In the above hypothetical case it is doubtful whether the remainderman (stranger) would have any reason to attack the Will, although he is eligible to do so, but he certainly had a *right to defend it* from the wife's attack. Both of them therefore had a *standing or status which commanded the compromise.* We do not believe that the government would claim that the property received by the said remainderman (stranger) would be subject to income tax because what he received under that compromise agreement was *an acquisition in devolution of said decedent's estate.* Judicial approval of the compromise agreement is merely one way in which a Probate Court may distribute an estate of a decedent.

Appellee's case is much stronger than the case assumed above because she had a right to attack the Will and assert her rights as the pretermitted daughter of the decedent. She had the *standing and status that commanded the compromise settlement and which was recognized by it.* The Probate Court in San Mateo, and the Honorable Judge James sitting therein, knew all about the settlement arrangements and approved the same and carried them into effect in accordance with the arrangement theretofore agreed upon by the parties. As hereinabove indicated, a number of things were done at the same time to accomplish a desired result. The various steps taken and the various forms used were only matters of *form* and were all a part of the means to an end; the *substance* of the transaction was to end the litigation and distribute to Mrs. Gavin 2/3 of 2/9ths of the estate and that is what was accomplished. It makes no difference what

formalities were gone through; it is the *substance* that counts.

When this tax matter first arose the Government was relying on the *Kearney* case *supra* (long since overruled), and in 1938 when the tax was paid the latest decision was that of the Second Circuit in the *Lyeth* case. That decision was diametrically opposed to the decision in the *Segebade* case, but the Circuit Court decision in the *Lyeth* case was later. Had the tax not been paid until after the Supreme Court decided the *Lyeth* case, in which that Court upheld the Fourth Circuit in the *Segebade* case and reversed the Second Circuit in the *Lyeth* case, it is our belief that the Government would never for a moment have contended that what Mrs. Gavin received was taxable. It is our belief and contention now that under the last mentioned Supreme Court decision, and under all of the other law of the land on the subject, Appellee is entitled to a refund of the income taxes involved herein which were so erroneously assessed against her.

In the case of *Lyeth v. Hoey,* 305 U. S. 188, the United States Supreme Court determined that the value of property received from the estate of a decedent by a person compromising his claim as an heir was not taxable as income. As pointed out by the honorable and very learned Chief Justice Hughes in his well reasoned opinion, it was Lyeth's *asserted claim as an heir* that placed the amount received in compromise within the exclusion of Section 22(b)(3) of the Internal Revenue Code. He states as follows:

> "There is no question that petitioner obtained that portion, upon the value of which he is sought to be taxed, because of his standing as an heir and of his *claim in that capacity.* It does not seem to be ques-

tioned that if the contest had been fought to a finish and petitioner had succeeded, the property which he would have received would have been exempt under the federal act. Nor is it questioned that if in any appropriate proceeding, instituted by him as heir, he had recovered judgment for a part of the estate, that part would have been acquired by inheritance within the meaning of the act. We think that the distinction sought to be made between acquisition through such a judgment and acquisition by a compromise agreement in lieu of such a judgment is *too formal to be sound,* as it disregards *the substance* of the statutory exemption. It does so, because it disregards the heirship which underlay the compromise, *the status which commanded that agreement and was recognized by it.* While the will was admitted to probate, the decree also required the distribution of the estate in accordance with the compromise and, so far as the latter provided for distribution to the heirs, it overrode the will. So far as the will became effective under the agreement it was because of the *heirs' consent and release* and in consideration of the distribution they received by reason of their being heirs. Respondent agrees that the word "inheritance" as used in the federal statute is not solely applicable to cases of complete intestacy. The portion of the decedent's property which petitioner obtained under the compromise did not come to him through the testator's will. That portion he obtained because of his heirship and to that extent he took in spite of the will and as in case of intestacy. The fact that petitioner received less than the amount of his claim did not alter its nature or the quality of its recognition through the distribution which he did receive." (Italics ours.)

In that case the learned Chief Justice, with reference to Section 22(b)(3), also said:

> "In exempting from the income tax the value of property acquired by 'bequest, devise, or inheritance,' Congress used comprehensive terms embracing *all acquisitions in the devolution of a decedent's estate.*" (Italics ours.)

As hereinabove stated, the Supreme Court, at the end of the opinion in that case, remarked that it was unnecessary to decide the *other points* raised in the case. In the briefs in that case it was contended by *Lyeth* that such receipts were not *income* under the Sixteenth (16th) Amendment. So, that is one of the points which that Court did not then *directly* decide, but did, we think, *indirectly* decide when it reversed the Second Circuit Court and affirmed the judgment of Judge Coxe in the District Court, because he had held that it was *capital* and *not income*. Furthermore, the Supreme Court reviewed the *Lyeth* case because of the conflict between the views of the Second Circuit in that case and the Fourth Circuit in the *Segebade* case, *supra,* and the Supreme Court approved the latter case, wherein the Fourth Circuit had held such receipts not to be *income*. Accordingly, it is our opinion that the Chief Justice would have directly held that such receipts were *not income* had it been necessary to so directly decide in disposing of the *Lyeth* case. It is also our opinion that the Chief Justice was referring to and speaking of the facts as they happened to be in that case, but so far as the *principle* he was enunciating was concerned, he would have reached the same result had it been our case that was before him instead of that of *Munro Lyeth.*

Likewise, the Board of Tax Appeals in *Keller v. Commissioner,* 41 B. T. A. 478 had the following to say:

> "The petitioner relies primarily and strongly upon *Lyeth v. Hoey,* 305 U. S. 188. The respondent with equal vigor contends that such decision is inapplicable, because petitioner *was not,* like the claimant in the cited case, *an heir of the decedent.* Though other cases are cited by both parties, it is apparent that the conclusion to be reached here rests largely upon construction and application of *Lyeth v. Hoey, supra.* In that case the Supreme Court had before it a grandson who objected to probate of the will of his grandmother, whose heir he was, and compromised with the other claimants under the will to the effect that the will should be probated and that he receive certain amounts, more than provided for him by the will. The Court held that the amounts received by him were not taxable as being received by inheritance, under section 22 (b) (3) of the Revenue Act of 1932. The petitioner herein argues that there is no essential difference between the situation here and that in the Lyeth case, *while the respondent contends that the Supreme Court stressed the fact that the contestant there was an heir, while here the petitioner was neither heir nor relative, but only a friend of the testatrix,* that the will making her a legatee was never probated, and that therefore, *Lyeth v. Hoey* is wholly inapplicable.
>
> We think the distinction made by the respondent is *not consonant with the principle,* in the mind of the Supreme Court in deciding the *Lyeth* case. The Court said:
>
> 'In exempting from the income tax the value of property acquired by "bequest, devise, or inheritance," Congress used comprehensive terms embracing *all*

acquisitions in the devolution of a decedent's estate. * * *'

We think that what the petitioner received was an 'acquisition in the devolution of a decedent's estate.' * * *" (Italics ours.)

In the *Keller* case, quoted from above, a compromise settlement agreement had been entered into and *"after a revocation of the facts in litigation,"* the agreement provided in effect that Charlotte Keller should receive one-third (⅓) of the estate and that *Max Horn* and his associates receive two-thirds (⅔) thereof; and it was agreed that *Max Horn* and associates should *assign* to *Charlotte Keller* one-third (⅓) of the estate to which they would or may become entitled to under the will of 1933, and that *Charlotte Keller* would *assign* to *Max Horn* two-thirds (⅔) of any and all property to which she would be entitled under the Will of May, 1929, and the Codicil of November, 1929. The agreement also provided that if the probate of the Will of 1933 should be revoked, *Max Horn* and associates at their own expense were to employ counsel and assist attorneys for *Charlotte Keller* to prosecute her petition to probate the 1929 Will and codicil. The latter agreed to deliver upon demand to the attorneys for *Max Horn* and associates a *dismissal with prejudice* of her petition for revocation of the probate of the Will of 1933. In December, 1934 the Court entered its decree, citing that *Max Horn had assigned* one-third (⅓) of his interest to Charlotte Keller. Later the Court distributed property to Charlotte Keller *as the assignee of Max Horn.* Certain distributions were also made to Charlotte Keller's attorneys.

The foregoing are some of the salient facts in the said *Keller* case which the Tax Court was dealing with in

deciding that case and it will be observed that the Tax Court looked at the *substance not the form* of the things that were done in connection with the compromise settlement. That is what should be done in the case at bar.

The Board of Tax Appeals, in the *Keller* case also pointed out that the decision in *Lyeth v. Hoey* could not mean that one must be an *heir* and take only in the one category of *inheritance* in order to be free from taxation upon receipts from a compromise.

It may be argued, as it was in the trial of the case at bar, that Charlotte Keller was a legatee under a former Will. That is true, and it also is true that she was a total *stranger* to the decedent. There was a later Will and therefore Charlotte Keller was not and could not be entitled to anything from the estate until she succeeded in *two,* and possibly *three,* pieces of litigation: (1) attacking and upsetting the later Will; (2) proving and admitting the former Will to probate; and, (3) defending it from attack. The point is that she had sufficient interest under the law to have a *right to litigate the matters,* which she did. It was *that right, that standing or status that commanded the compromise settlement* and what she took under it was therefore an *acquisition in devolution of the decedent's estate.*

So, with the appellee here, she had an interest sufficient under the law to attack the Will of Mr. Flood. She had the *right to assert her claims and she had the right to litigate for her share as a pretermitted daughter.* She was doing that very thing, and had been engaged therein for over six (6) years, and it was a determined fight, if there ever was one. So, we insist that she too, on *principle* and under the authorities, had *the right, the standing and*

the status which commanded the compromise settlement and which was recognized by it, regardless of the formalities that may have been indulged in consummating the settlement. Therefore, what she received in settlement was likewise *an acquisition in devolution of the decedent's estate.*

We refer also to the following cases which support appellee:

Estate of Lilly B. Howard v. Commissioner, B. T. A., Docket No. 109188;

Helen Irene Rhodes v. Commissioner (1944), Tax Court Docket No. 1709;

Sage, et al v. Commissioner (C. C. A.), 1941, 122 F. (2d) 480.

The *Howard* case is directly in point. In that case, one Mary Alice Castro filed a petition for determination of heirship against the decedent's estate. She claimed to be the illegitimate daughter of the decedent and as such was entitled to one-half of the estate. A trial was had with a jury and a verdict was rendered that she was decedent's daughter. A new trial was granted, and the petitioner appealed to the Supreme Court of the State of California alleging error in the granting of a new trial. Pending the appeal, a compromise settlement was entered into whereby Mary Alice Castro's claim and interest in the estate were settled for $15,000. The Probate Court approved the settlement and ordered the executors to pay the $15,000., which sum was paid by the estate. In preparing the estate tax return, the executors deducted the sum of $15,000 which was paid to Mary Alice Castro as an allowed claim against the estate. The Commissioner

contended that the sum paid to her was unallowable as a deduction, for the reason that it *"partakes of the nature of the inheritance."* The Court said:

> "* * * to say the least, the compromise was based upon *her claim that she was such a daughter.* * * *" (Italics ours.)

The *Sage* case cited, *supra,* involved the following situation: One *John Sage* died testate leaving a widow who was adjudged incompetent two months later and for whom guardians were appointed by the Orphan's Court of New Jersey. Testator, left an estate of about $450,000. By his Will he gave his wife the household effects and a legacy of about $42,000. After other specific and pecuniary legacies, he bequeathed the converted residuary estate to the *Lord Provost* of Glasgow, Scotland, outright, and added a request that the *Lord Provost* distribute the same to certain institutions caring for the blind, etc. The Will was offered for probate before the Surrogate Court in New York. The guardians of *Mrs. Sage* opposed. The Surrogate in New York directed the Will be transmitted to the Surrogate of Bergen County, New Jersey, and the New York Court dismissed all proceedings. The Will was then filed for probate in Bergen County, New Jersey, and citations were issued. At that stage a compromise settlement was made whereby the guardians were to *withdraw all objections to the probate and they were to consent to the probate.* The *Lord Provost* agreed to pay the guardians 25% of the gross amount payable to the *Lord Provost* under the Will. The Guardians petitioned the Orphan's Court for and obtained approval of the compromise agreement. The same day the Will was admitted to probate in Bergen County. When the estate was closed distribution was made to the *Lord Provost.*

There was no provision in the decree for the widow or her guardians. The executors of the estate were not parties to the compromise agreement, nor was the agreement ever a part of the probate proceedings. The *Lord Provost* paid the guardians pursuant to the agreement.

In that case the Third Circuit Court said:

> "If these matters be material, it should also be noted, in passing, that the decree of distribution, as well as the decree settling the executors' account, was entered by *the same court acting by the same judge* as had approved the compromise agreement prior to *and as a part of the withdrawal of the objections to the will, and the probate thereof.*" (Italics ours.)

The Court pointed out that what the widow received was an *inheritance* and was subject to estate tax. The Court also stated that the *Sage* case and the *Lyeth* case were the same in *principle,* even though one involved *income tax* and the other, *estate tax.* They said that that was merely a difference in words. The Court pointed out that the widow had the *right to contest the will* "(which, incidentally, was being exercised)" and that she therefore had the *status to command the compromise agreement.*

In the *Lyeth* case, the sole issue was whether the acceptance of a lesser amount as the result of a compromise of his asserted claim as an heir constituted taxable income. This is the precise question in the instant case. Here appellee asserted that she was a pretermitted heir and as a result of her asserted claim she received a substantial amount in compromise.

The Government is attempting to draw a distinction between the *Lyeth* case and the case at bar and persists in referring to appellee's claim to be an heir. The fact is

that she was not merely claiming to be an heir. She was asserting and was prepared to, was proving, and did, in our opinion, prove that she was an heir. She had, among other things, proved that from the time she was three (3) months of age she lived in the home of James L. Flood as a member of his family and had been raised and educated by him and otherwise had been treated and recognized as his daughter. A reading of the *Estate of Flood* in 217 Cal. 763 [R. 59-84] should convince anyone of that. We fail to see any distinction, in *principle* between the *Lyeth* case and the case at bar. Mrs. Gavin claimed that she was the pretermitted daughter of the decedent. She had the right to and did assert that fact; and she had the right to and did litigate the same to recover what she was entitled to. It was her *standing and status in that respect that commanded the compromise settlement* and what she received was *an acquisition in devolution of the Flood estate*. Any reasonable person knows that no one, let alone the able counsel representing the *Flood* estate, would have settled with her for 2/3rds of 2/9ths of that estate unless her position was very strong and substantial and the success of her litigation very imminent. What could possibly have been accomplished in the trial of the case at bar by having the District Court decide the question of heirship? What would that prove either way? Certainly, from a logical standpoint, it would not follow that the ultimate decision in Redwood City would have been the same as that in the District Court. Furthermore, what would be the sense of a person compromising a case if he then had to retry the case he settled in order to establish his rights with reference to taxes?

The Government contends that in order to be entitled to exemption, the taxpayer must prove that the amount

realized was a transfer by reason of the decedent's death; that the taxpayer must also *prove* that she is in fact an heir; and also *prove* that the amount was paid to her as an heir. We do not agree with this contention. Obviously, Mrs. Gavin couldn't assert her claim as a pretermitted daughter until after the death of Mr. Flood. When he died testate and she discovered she was not named in his Will, she had the right to and did in no uncertain manner assert that she was his daughter and demanded 2/9ths of his estate as his pretermitted heir. If he had named her in the Will and given her nothing she couldn't contest until after his death. It seems obvious therefore that her rights as such pretermitted daughter accrued upon his death and that the transfer of what she received came about by reason of his death. She got it because of her litigation to prove that she was his daughter and pretermitted heir and the *Flood* estate and the representatives thereof compromised with her for 2/3rds of 2/9ths of her share. If that does not fulfill the requirements necessary to make it *an acquisition in devolution* of Mr. Flood's estate, we apparently do not understand the *principle* underlying that doctrine.

Suppose there were various formalities in connection with the compromise settlement saying pink is blue or black is white, what of it? So was there in the *Keller* case, *supra,* the *Sage* case, *supra,* and many others. We all know that cases, involving much less than this one, are settled time and again and that releases absolving defendant from blame and liability are signed (when he pays the plaintiff). That, in *substance,* does not mean that the defendant was blameless and without liability because obviously the injured party would not sign such a release unless he received a satisfactory settlement. Sometimes

defendant arranges to settle with plaintiff and plaintiff consents to judgment in favor of defendant. What is the difference? It is the *substance* of the thing, not the *form* that counts. Likewise, with Mrs. Gavin in this case. The loss of this case was undoubtedly a "bitter pill" for the representatives of the *Flood* estate and it's counsel, and it may be that it made them feel better to handle matters in the form employed in the settlement. It is also easy to understand that they may have been thinking of possible future claims. Be that as it may, in *substance* they settled with her and distributed 2/3rds of 2/9ths of the estate to her.

As stated by the Honorable Judge Harrison in his decision of this case, if *form* is disregarded for *substance,* the money received under the decree of distribution in the Flood estate was *an acquisition in the devolution of said estate.* In *substance* this case is directly within the scope of the rule laid down in the *Lyeth* case, *supra,* and except for the *form* in which the compromise was effected, the Government concedes that the property received by her would not be taxable.

In the case of *Volunteer State Life Insurance Company v. Commissioner,* 35 B. T. A. 491, the Board said:

> "A 'consent' judgment has been defined as a contract of the parties spread upon the record with approval and sanction of a court of competent jurisdiction. Weaver v. Hampton, 161 U. S. 480; 201 N. C. 798. A 'consent decree' is *not a judgment of the court,* but is a contract between the parties entered into of record with the court's consent, and is not necessarily based upon pleadings or records in the case. Standard Supply Co. v. Delmar Coal Co., 110 W. Va. 560; 158 S. E. 907. The order in question was a disposition of the suit by the parties and not

by the Board, Berry v. Somerset R. Co., 89 Me. 552; 36 A. 904. It was *not a judicial rendition on the merits* and cannot be the basis of a claim of *res judicata* in the present proceeding. Almours Securities, Inc., 35 B. T. A. 61. * * *" (Italics ours.)

We therefore respectfully submit that in the case at bar, it is the *substance* of the situation and not the *form* by which the settlement was consummated that controls. We are firmly convinced and believe that we have shown that what Mrs. Gavin received in the compromise settlement comes squarely within the principle and spirit, reason and intent of Section 22 (b)(3) of the Revenue Act of 1934 because it was an *acquisition in devolution of the Flood estate.*

As we have heretofore pointed out there is no merit in the appellant's contention that Mrs. Gavin received the settlement from the heirs and not from the estate. By necessity the heirs, devisees and legatees had to give up something; there is no other way to take care of a pretermitted heir. Furthermore, as stated in the *Segebade* case, *supra,* the *Sage* case, *supra,* the *Keller* case, *supra,* and other cases, it makes no difference who does it or how they do it. The important thing is that there is a settlement of a contest against the estate under which the recipient gets part of the estate. Again we say it is the *substance* of the thing that controls, not the *form* or the manner in which the result is accomplished.

In *Keller v. Commissioner, supra,* the Board of Tax Appeals said:

"We think that what petitioner received was an *'acquisition in the devolution of a decedent's estate.'* It was distributed to her directly by the probate

court, as was the remainder of the estate to the legatees or devisees. It is true that such *distribution designated her as assignee, but the assignment was because of compromise of her own claim as legatee.*" (Italics ours.)

In *Helen I. Rhodes v. Commissioner, supra,* the compromise there was an agreement between the petitioner, who was contesting her father's will, and her brother, and the brother agreed *to purchase or secure a third party to purchase* the shares of stock which the petitioner was entitled to under the will. It is certain that the facts of this case are much weaker than our case, and yet the Board held that the amount received from her brother *did not constitute income* by reason of the compromise of her claim. See also *Helen R. Goldman v. Commissioner,* B. T. A. Docket No. 112259.

Summary and Conclusion.

As hereinabove shown, on principle as well as under the authorities, the value of the money and property received by appellee was not *income* within the Sixteenth (16th) Amendment to the United States Constitution or in any sense of the word. Accordingly, it should not be necessary to consider whether it comes within any exclusion or exemption provision of the Revenue Act of 1934 because the provisions of that Act do not apply until there is *income* to which it may be applied. It should therefore be unnecessary for appellee to bring herself within any exclusion or exemption provision of the Act unless and until it is first determined that what she received, in compromise of her litigation to recover her share as the pretermitted daughter of James L. Flood,

was *income* within the said Constitutional Amendment. We know of no theory other than that expounded in the *Kearney* case, *supra,* which has been repudiated and overruled, under which it could be so held. Such an unsound and far-fetched theory is contrary to fact and repugnant in principle.

Even if there was any plausible basis under which it could be said that amounts received in settlement under such circumstances constituted income within the Sixteenth (16th) Amendment, the settlement appellee received would, on principle and under the above mentioned authorities, be an *inheritance,* or at least an *acquisition in devolution of the Flood estate,* and would fall squarely within the intent, spirit and reason of the exclusion of Section 22 (b)(3) of the Act.

We should bear in mind, as shown by the record [R. 59-84], that appellee, when a small child, lived in the home of Mr. Flood and his first wife and was raised by them. There was great love and affection between Mr. Flood and the appellee and also between the latter and the then Mrs. Flood.

After Mr. Flood married his deceased first wife's sister, the present Maud Lee Flood, this little girl travelled with them and made trips with them to the Orient and elsewhere. Thereafter, appellee was placed in a convent where she was maintained and educated by Mr. Flood. In the meantime Mr. Flood had two children by Maude Lee Flood, namely, James Flood and Mary Emma Flood (now Stebbins).

After his death in February, 1926, she discovered that she was not named in his Will and that his Will provided for his estate to go to Maude Lee Flood, James Flood, Jr.,

Mary Emma Flood (now Stebbins) and certain other beneficiaries. She thereupon asserted her rights and in March, 1927, filed a petition for partial distribution to recover her share (2/9ths of the estate) as the pretermitted daughter of the decedent. She prosecuted the litigation vigorously clear through the Supreme Court of California and was determined in her efforts to get her just share of said estate. Between May, 1933 and February, 1934, after years of litigation, a compromise settlement was arranged and agreed upon and the same was consummated as hereinabove set forth and the money and property was distributed to her and her assignees. Certainly the amounts received by her under the circumstances was not and could not be classified as *income*. It was an *inheritance* and it is obvious that inheritance taxes and estate taxes were paid on it. Certainly, what she received was *an acquisition in devolution of that estate.*

To assess an income tax on the proceeds of said settlement was not only erroneous and contrary to law but quite unjust and the Judgment of the Honorable United States District Court for a refund thereof and interest thereon should be sustained and affirmed.

Respectfully submitted,

LESLIE L. HEAP,

Attorney for Appellee.

Of Counsel:

HAROLD A. THOMPSON, ESQ.

APPENDIX

United States Constitution, Amendment Sixteen (16)

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Revenue Act of 1934, c. 277, 48 Stat. 680:

Sec. 21. Net Income.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

Sec 22. Gross Income.

(a) **General Definitions.**—"Gross income" includes gains, profits and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) **Exclusions from Gross Income.**—The following items shall not be included in gross income and shall be exempt from taxation under this title:

* * * * * * * * *

(3) **Gifts, Bequests, and Devises.**—The value of property acquired by gift, bequest, devise, or inheritance (but

the income from such property shall be included in gross income);

* * * * * * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) **General Rule.**—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

(b) **Definition of Capital Assets.**—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * * * * * *

PROBATE CODE OF CALIFORNIA (1931), DIV. I, CHAP. IV:

Sec. 90. **Rights of children and grandchildren.** When a testator omits to provide in his will for any of his children, or for the issue of any deceased child, whether born before or after the making of the will or before or after the death of the testator, and such child or issue are unprovided for by any settlement, and have not had an equal proportion of the testator's property bestowed on them by way of advancement, unless it appears from the will that such omission was intentional, such child or such issue succeeds to the same share in the estate of the testator as if he had died intestate.

Sec. 91. **Sources of unmentioned child's share.** The share of the estate which is assigned to a child or issue omitted in a will, as hereinbefore mentioned, must first be taken from the estate not disposed of by the will, if any; if that is not sufficient, so much as may be necessary must be taken from all the devisees or legatees, in proportion to the value they may respectively receive under the will, unless the obvious intention of the testator in relation to some specific devise or bequest, or other provision in the will, would thereby be defeated; in such case, such specific devise, legacy or provision may be exempted from such apportionment, and a different apportionment, consistent with the intention of the testator, may be adopted.

PROBATE CODE OF CALIFORNIA (1931, 1933), DIV. III, CHAP. XVI, ART. III:

Sec. 1020. **Final distribution: Procedure.** Immediately upon the final settlement of the accounts of the executor or administrator, or at any subsequent time, upon the

application of the executor or administrator, or of any heir, devisee or legatee, or his assignee, grantee or successor in interest, and after notice given for the period and in the manner required by section 1200 of this code, the court must proceed to distribute the residue of the estate among the persons entitled thereto. Any person interested in the estate or any coexecutor or coadministrator may resist the application.

PROBATE CODE OF CALIFORNIA (1931), DIV. III, CHAP. XVI, ART III:

Sec. 1021. **Decree of distribution.** In its decree, the court must name the persons and the proportions or parts to which each is entitled, and such persons may demand, sue for, and recover their respective shares from the executor or administrator, or any person having the same in possession. Such order or decree, when it becomes final, is conclusive as to the rights of heirs, devisees and legatees.

CIVIL CODE OF CALIFORNIA (1872), DIV. I, PT. III, TIT. II, CHAP. II:

Sec. 230. **Adoption of illegitimate child.** The father of an illegitimate child, by publicly acknowledging it as his own, receiving it as such, with the consent of his wife, if he is married, into his family, and otherwise treating it as if it were a legitimate child, thereby adopts it as such; and such child is thereupon deemed for all purposes legitimate from the time of its birth. The foregoing provisions of this chapter do not apply to such an adoption.